



SUB OR SCRUB

WHY TO KEEP A CLOSE EYE ON YOUR SUBCONTRACTORS

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For so many contractors, profit or loss on a project depends on whether subcontractors deliver or fall down on the job. Some companies recognize this and establish best practices that provide protections at each critical phase. But too often, businesses don't recognize that their success — even their survival — is so crucially tied to their subs. Take measures to protect against poor subcontractor performance.

Knowing Your Sub

Shockingly, many businesses do little, if any, checking on the qualifications of subs that they have never worked with before. Instead, contractors look for the lowest price or the nearest group of warm bodies that can jump on a job already behind schedule. As a result, poorly qualified subs are hired, and they can't keep the project staffed. Or the sub hires a rolling parade of unqualified workers. Then the sub's work is either slow or sloppy and must be redone. The contractor that started out with high hopes that it could make a decent profit realizes that it has an expensive mess on its hands. Been there?

Maybe you've encountered this classic calamity: the sub is broke and uses your payments to satisfy invoices and payrolls due on its other jobs. Your project becomes a catastrophe waiting to happen. We have seen contractors sued by the employees of their sub even though the contractor had nothing to do with failure to pay those workers. In other cases, the general contractor faces liens from vendors and sub-subcontractors.

So, first and foremost, know your sub. Knowing your sub means that you have determined whether the sub can perform the functions of the subcontract and that it doesn't have other problems that will interfere with your project.

Start with the basics. References are good, but they are not foolproof and circumstances change. Also get financial statements. These should include recent operating statements showing income, expenses and, hopefully, profits, as well as a current balance sheet, which provides the assets and liabilities of the sub. If the sub will be providing a significant amount of work for you, visit its current projects and talk to its vendors and bank about its creditworthiness. If all of this sounds like a lot of work, think about the effort it takes to clean up the mess a bad sub can create. In one situation, the poorly trained employees of a concrete subcontractor ruined every balcony on hundreds of apartment units. It also

turned out that the sub was barely solvent. The bad balconies were only discovered after residents moved in. The residents were banned from their balconies for months — which didn't make them or the project owner happy — while the engineers designed a fix. Then, bracing was added to each of the balconies at an expense of hundreds of thousands of dollars. Whoops! There goes the profit on that job. Some folks at the general contractor certainly wished that they had done more homework and discovered that this sub was not up to the task.

Adding Protection

Even if you start with a good sub, bad stuff can happen. You need protection. This can take a variety of forms, but the most important include the following:

Insurance: Require your sub to buy appropriate insurance. This includes commercial general liability insurance for injury or death, workers' compensation insurance, and property insurance. Special insurance may be required depending on the job, such as hazardous materials insurance. Make sure that your company and other appropriate parties are listed as additional insured on this insurance so that you receive direct protection from these policies. You may even need to be the named insured under certain insurance policies so that you control the payout of the insurance proceeds. Finally, make sure to obtain certificates of insurance demonstrating that your subs actually bought the required insurance, or get the entire insurance policy.

Bonds: Some of the best protections against subcontractor defaults are payment and performance bonds. These bonds require a creditworthy third party, the "surety," to compensate you if the sub fails to pay others or to perform work. However, certain bond forms reduce your protection. For example, some bonds give the surety the option to bring in another sub to correct or finish the work. Once you already have a problem on your hands, you should have the right to determine who fixes the problem and not risk the surety hiring the cheapest replacement to put a bandage on the mess.

Lien waivers: Good project management requires building the project on paper. Put in place the processes and paperwork to ensure that you have protection against problems that your subs could create. Prepare lien waivers that comply with local law, that confirm payment by your sub of amounts owed by them to others and that acknowledge receipt of payment from you. These documents should include a waiver of the sub's rights to assert liens or other claims. Your lien waivers should also obligate each sub to indemnify you against legal fees and other sums you incur if the sub fails to pay others. Most importantly, get those lien waivers with each payment you make to a sub.

Subcontracts: All of these protections should be included in your subcontract. Don't rely on a handshake or an exchange of emails. Don't use outdated forms. Many states have laws that regulate what you can and can't require of subcontractors. In some jurisdictions, subs can't be required to waive their lien rights in advance of payment. In other states, you are limited in how much you can retain from payments due to subs. Some specific legal provisions can provide tremendous protection. For example, a properly drafted "pay if paid" provision allows you to wait until you are paid by your customer before you pay your subs. In reality, most businesses botch this provision. Another handy provision is a cross-default clause. This provision allows you to subtract money otherwise due under a subcontract if that sub has defaulted under another subcontract with your company.

Tricks and Traps

Performing on time and on a budget is all but impossible when you are tripped up by “gotchas.” For example, under the law, if you pay a sub before it is entitled to payment under its subcontract, you may release the surety from its obligations under the bond. The problems that can come out of left field are countless. If you write a letter accusing your sub of defective work, your customer can use this letter against you to prove your work was defective. Or your subs may bury escape hatches in their qualifications and assumptions exhibit to the subcontract, relieving the sub of obligations that you thought you had shifted to the sub in your form subcontract.

Further, don’t forget to incorporate special prime contract requirements into your subcontracts. If you are performing certain work for the federal government, you may be required to collect certified payrolls showing that your subs have been paying minimum “prevailing wages” under applicable legal requirements. Indeed, each of your customers may have its own unique requirements that are not anticipated by the subcontract form you create. Often you need to create a rider for your subcontract that obligates subs to comply with these special requirements.

Managing your subs requires good procedures and contracts, knowledge of the law and discipline to follow the processes that protect your bottom line.

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